181 (2)

No. 10-749

In the Supreme Court of the United States

RICHARD HONGSERMEIER, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly determined that the Tax Court did not abuse its discretion by refusing to extinguish petitioners' liability under 26 U.S.C. 6601 for underpayment interest on their tax deficiencies.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-36a) is reported at 621 F.3d 890. The opinion of the Tax Court (Pet. App. 51a-182a) is unreported, but is available at 91 T.C.M (CCH) 1086. The supplemental opinion of the Tax Court is unreported, but is available at 92 T.C.M. (CCH) 245.

JURISDICTION

The judgment of the court of appeals was entered on September 1, 2010. The petition for a writ of certiorari was filed on November 30, 2010. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. This multi-party tax litigation originated when petitioners, along with approximately 1800 other taxpayers, claimed tax deductions based on their participation in a tax shelter promoted by Honolulu businessman Henry Kersting. See *Dixon* v. *Commissioner*, 62 T.C.M. (CCH) 1440 (1991). After the Commissioner of Internal Revenue (Commissioner) disallowed the claimed deductions, petitioners and more than 1300 of the other taxpayers filed petitions in the Tax Court contesting the disallowance. Pet. App. 5a-6a. The parties agreed to employ a "test-case" procedure under which petitioners and a few other tax-shelter participants would serve as test-case taxpayers, and most of the other participants agreed to be bound by the Tax Court's opinion in the test cases. *Id.* at 6a-7a, 53a & n.3, 68a-69a.

Prior to the test-case trials, Kenneth McWade, the Internal Revenue Service (IRS) attorney trying the cases, and William Sims, his immediate supervisor, entered into contingent settlement agreements with test-case taxpayers John and Maydee Thompson and other test-case taxpayers. Pet. App. 7a-8a, 53a-54a. The agreement with the Thompsons, which required the Thompsons to remain in the case as test-case taxpayers, was not disclosed to the Tax Court, to counsel for the other taxpayers, or to other lawyers in the IRS Office of Chief Counsel. *Id.* at 8a, 82a-83a. In addition, at trial, McWade acted in a deceptive manner designed to prevent the Tax Court and the other taxpayers from learning of the settlement agreements. *Id.* at 8a-9a.

Following the trial, the Tax Court ruled in favor of the Commissioner on the interest deductions claimed by petitioners and the other tax-shelter participants. *Dixon*, 62 T.C.M. (CCH) at 1440. The Tax Court found

that Kersting's tax-shelter plans involved sham transactions that did not entail the creation of any genuine indebtedness or the actual payment of interest, and that the taxpayers therefore were not entitled to deduct interest they purportedly had paid in connection with their participation in the tax shelters. *Id.* at 1506; see *Kersting* v. *United States*, 206 F.3d 817, 819 (9th Cir. 2000) (holding that Kersting tax shelters involved "sham transactions" and "fraudulent interest deductions").

Sims's and McWade's superiors at the IRS did not learn of the settlement agreements until after the Tax Court had tried the test cases, issued its opinion, and entered its decisions. Pet. App. 10a-11a, 88a. Thereafter, in June 1992, the Commissioner filed motions in three of the test cases, including the Thompsons' case, advising the Tax Court that Sims and McWade had entered into contingent settlement agreements that had not been disclosed to the court, the other taxpayers, or their counsel. *Id.* at 11a, 89a. The Commissioner requested that the Tax Court vacate the decisions it had entered in the test cases and hold an evidentiary hearing to determine the effect, if any, of the undisclosed settlement agreements on the trial and the Tax Court's decisions. *Ibid.* The Tax Court ultimately entered a revised decision in the Thompsons' case consistent with their settlement agreement, but the court otherwise denied the Commissioner's motion to vacate. *Id.* at 11a, 90a, 94a-96a. The Tax Court also denied the Commissioner's request for an evidentiary hearing. *Ibid.*

2. In *DuFresne* v. *Commissioner*, 26 F.3d 105 (9th Cir. 1994) (per curiam), cert. denied, 514 U.S. 1036 (1995), the court of appeals vacated the Tax Court's decision in *Dixon* and remanded the case to the Tax Court to determine whether the misconduct by the Commis-

sioner's attorneys in failing to disclose the settlement agreements constituted a structural defect or instead was harmless error. After discovery and extensive evidentiary hearings, the Tax Court concluded that the misconduct did not constitute a structural defect or fraud on the court, and that it was harmless error. *Dixon* v. *Commissioner*, 77 T.C.M. (CCH) 1630, 1700, 1712, 1716 (1999). The Tax Court explained that the test-case taxpayers were afforded a fair trial despite the government's misconduct, and that the misconduct was not material to the outcome of the case. *Id.* at 1712, 1716.*

3. In *Dixon* v. *Commissioner*, 316 F.3d 1041 (9th Cir. 2003), the court of appeals reversed. The court of appeals did not disagree with the Tax Court's finding that petitioners and the other tax-shelter participants had not been prejudiced by the IRS attorneys' misconduct. The court nevertheless held that the misconduct constituted fraud on the court for which the Commissioner should be sanctioned. *Id.* at 1046. The court rejected, as an unduly extreme sanction, petitioners' request that the court eliminate all tax liabilities of the tax-shelter participants. Instead, the court remanded the case to the Tax Court with instructions to "enter judgment in favor of Appellants and all other taxpayers properly before * * * th[is] [c]ourt on terms equivalent to those provided in the settlement agreement with Thompson and the IRS." *Id.* at 1047; see Pet. App. 14a.

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* The Tax Court found that the misconduct had not affected the outcome of the test cases because, as the court had previously concluded: (1) the Kersting transactions were shams; (2) the Kersting promissory notes did not constitute genuine debt; and (3) interest on Kersting loans was not paid within the meaning of 26 U.S.C. 163(a). *Dixon*, 77 T.C.M. (CCH) at 1712.

The court left "to the Tax Court's discretion the fashioning of such judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided for in the Thompson settlement." 316 F.3d at 1047 n.11; see Pet. App. 14a n.11.

4. On remand, the Tax Court determined that, in order to put the other tax-shelter participants in the same position as the Thompsons, it would reduce their tax deficiencies by 63.37%. Pet. App. 170a-171a; see *id.* at 16a-17a. The Tax Court accorded other benefits to the tax-shelter participants by eliminating their outstanding penalties and additions to tax, even for non-Kersting-related tax deficiencies. *Id.* at 17a-19a.

In addition, the Commissioner voluntarily agreed to suspend the running of interest on all remaining deficiencies beginning in June 1992 and continuing until 90 days after the Tax Court entered its decisions on remand. Pet. App. 174a. The Tax Court determined that this was an appropriately targeted response to the long delay in the resolution of these cases resulting from the fraud on the court committed by the Commissioner's attorneys. *Id.* at 180a; see *id.* at 33a & n.12. Petitioners and the other tax-shelter participants therefore received a significant suspension of interest, but they remained liable under 26 U.S.C. 6601 for the interest that had accrued on their remaining tax deficiencies from December 31, 1986, to June 1992, as well for any additional interest that began to accrue on September 13, 2007, the date that was 90 days after the Tax Court's decisions were entered.

The Tax Court rejected petitioners' contention that, in order to place them in the same position as the Thompsons, the court should also relieve petitioners and the other tax-shelter participants of liability for under-

payment interest on their remaining tax deficiencies from December 31, 1986, to June 1992. The Tax Court explained that the Thompsons' settlement agreement with the IRS had not relieved them of their liability for underpayment interest on their remaining tax liabilities during that period. Pet. App. 74a-76a, 98a-102a, 122a-123a. Rather, the Thompsons had paid no interest after 1986 because Mr. Thompson had made an advance payment of interest in 1986, a step that any of the other tax-shelter participants could have taken to stop interest from accruing. *Id.* at 74a-76a, 98a-102a, 122a-124a.

5. The court of appeals affirmed. Pet. App. 1a-36a. The court concluded that the Tax Court had properly followed the *Dixon* mandate and had not abused its discretion in determining that petitioners and the other tax-shelter participants would be in the same position as the Thompsons if (1) petitioners' tax liability was reduced by 63.37%, and (2) petitioners remained liable for the underpayment interest required by 26 U.S.C. 6601 on their remaining tax liabilities, excluding the interest that the Commissioner had voluntarily agreed to extinguish. Pet. App. 20a-28a, 32a-36a. The court of appeals explained that this solution "fairly and reasonably complied" with the court's prior instruction that the Tax Court "'put these taxpayers in the same position as provided for in the Thompson settlement'" "'to the extent possible and practicable.'" *Id.* at 36a (quoting *Dixon*, 316 F.3d at 1047 n.11).

The court of appeals specifically agreed with the Tax Court's finding that the Thompson settlement "did not involve a cancellation or reduction in the interest owed by Thompson on his tax deficiencies." Pet. App. 35a. The court pointed out in that regard that those taxpayers who did not make advance payments sufficient to

satisfy their tax liabilities continued to enjoy the economic benefits of their funds, while Thompson had "lost the use of his funds by paying all tax deficiencies and interest in 1986 and 1987." *Ibid.* For that reason, the court explained, "[c]ancelling [petitioners'] interest payments beyond 1986 would accord [petitioners] a benefit well beyond that received by the Thompsons." *Id.* at 36a. The court of appeals therefore affirmed the Tax Court's ruling that petitioners and the other tax-shelter participants remained liable for the underpayment interest on their remaining tax deficiencies for the period between December 1986 and June 1992, as well as for any additional interest accruing after September 13, 2007. *Ibid.*

ARGUMENT

Petitioners contend (Pet. 6-13) that, as a sanction for misconduct committed by the Commissioner's attorneys, they should be excused from paying interest incurred between December 1986 and June 1992 on their remaining tax liabilities. The court of appeals correctly rejected that contention, and its decision does not conflict with any decision of this Court or another court of appeals. In addition, the court's ruling as to the appropriate sanction for attorney misconduct under the unusual circumstances presented here raises no legal issue of continuing importance. See *United States* v. *Johnston*, 268 U.S. 220, 227 (1925) ("We do not grant * * * certiorari to review evidence and discuss specific facts."). Further review is not warranted.

1. The narrow question presented to the court of appeals was whether the Tax Court had properly followed and implemented the appellate mandate in *Dixon* to accord all the Kersting tax-shelter participants the

benefits of the Thompson settlement. The court of appeals concluded that the Tax Court's decision "fairly and reasonably complied with * * * [its] direction to 'put these taxpayers in the same position as provided for in the Thompson settlement'" "'to the extent possible and practicable.'" Pet. App. 36a (quoting *Dixon* v. *Commissioner*, 316 F.3d 1041, 1047 n.11 (9th Cir. 2003)). Petitioners contend (Pet. 10-13) that they will not receive the same benefits as the Thompsons unless they are relieved from paying underpayment interest incurred between December 1986 and June 1992 on the 36.63% of their tax deficiency that they have been ordered to pay. That argument reflects a misunderstanding of the relevant facts.

The record shows that Mr. Thompson made an advance payment of underpayment interest in 1986, and that in 1987 he paid the tax deficiencies remaining after his settlement agreement. Thus, as the Tax Court found (Pet. App. 74a-76a, 98a-102a, 122a-124a), the Thompsons paid no interest after 1986, not because their settlement agreement with the IRS relieved them of the interest liability imposed by 26 U.S.C. 6601, but because Mr. Thompson's advance payment of interest in 1986, combined with his full payment in 1987 of the taxes due under the Thompsons' settlement agreement, fully satisfied the Thompsons' obligations under Section 6601. The court of appeals agreed with that analysis, see Pet. App. 34a-36a, and it concluded that "[c]ancelling [petitioners'] interest payments beyond 1986 would accord [petitioners] a benefit well beyond that received by Thompson," *id.* at 36a. The court of appeals correctly decided that fact-bound question, and its decision raises no legal issue of continuing importance.

2. Petitioners further contend (Pet. 6-10) that the Tax Court should have extinguished their liability for underpayment interest after 1986 because collecting interest would allow the United States to profit from its fraud, in contravention of this Court's decision in *Hazel-Atlas Glass Co.* v. *Hartford-Empire Co.*, 322 U.S. 238 (1944), overruled on other grounds by *Standard Oil* v. *United States*, 429 U.S. 17 (1976). Petitioners' reliance on *Hazel-Atlas* is misplaced.

In *Hazel-Atlas*, officials and attorneys of a company whose patent application was pending "determined to have published in a trade journal an article signed by an ostensibly disinterested expert which would describe the [relevant invention] as a remarkable advance in the art of fashioning glass by machine." 322 U.S. at 240. The company submitted the article in support of its pending patent application (which the Patent Office granted), and the company's attorneys relied on it in subsequent infringement litigation, ultimately obtaining a judgment that the patent was valid and infringed. *Id.* at 240-241. After the company's deceit came to light, this Court held that the court of appeals had equitable power to set aside the fraudulently obtained judgment in the infringement suit, notwithstanding that the judgment had become final. *Id.* at 250.

In this case, consistent with *Hazel Atlas*, the original decisions entered by the Tax Court in *Dixon* were vacated by the court of appeals because of the fraud committed by the Commissioner's attorneys. *Dixon*, 316 F.3d at 1047-1048. The court of appeals determined in *Dixon* that the appropriate equitable relief was to afford the Kersting tax-shelter participants the benefits of the Thompson settlement. *Id.* at 1047. The Tax Court properly followed that mandate, Pet. App. 34a-36a, and

Hazel-Atlas did not require the Tax Court to grant petitioners additional equitable relief.

Contrary to petitioners' contention, the court of appeals' decision in this case does not allow a sanctioned party to profit from its fraud. Because the Commissioner was required to give all tax-shelter participants the same settlement terms as the Thompsons, the United States has lost tens of millions of dollars in taxes, interest, and penalties that otherwise would have been owed by taxpayers who claimed deductions based on their participation in a tax shelter that involved "sham transactions" and "fraudulent interest deductions." See *Kersting* v. *United States*, 206 F.3d 817, 819 (9th Cir. 2000). Thus, far from profiting from the fraud of his attorneys, the Commissioner has been severely sanctioned for that fraud.

In *Dixon*, the Tax Court determined that the attorney misconduct was not material to the trial of the test cases and that the outcome would have been the same even if no misconduct had occurred. *Dixon* v. *Commissioner*, 77 T.C.M. (CCH) 1630, 1712, 1716 (1999). The court of appeals in *Dixon* did not disagree with that finding. Rather, the court concluded that the attorney misconduct constituted fraud on the court that warranted sanctions against the Commissioner, regardless of whether the taxpayers were prejudiced by the fraud. *Dixon*, 316 F.3d at 1046-1047.

Thus, if no misconduct had occurred, petitioners would have been liable for the full amount of their tax deficiencies and interest thereon from the time their taxes were due to be paid until the date they were paid. 26 U.S.C. 6601; see Pet. App. 120a-123a. Instead, because of the sanction imposed by the court of appeals, petitioners received a 63.37% reduction in their tax defi-

ciencies and a corresponding 63.37% reduction in their liability for underpayment interest under Section 6601. In addition, the Commissioner voluntarily agreed to suspend the running of underpayment interest from June 1992 until 90 days after the Tax Court entered its final decisions in these cases, which ultimately was a period of approximately 15 years. *Id.* at 33a & n.12, 180a-181a.

Petitioners do not challenge the Tax Court's determination (see Pet. App. 170a-171a) that, consistent with the terms of the Thompson settlement, petitioners remain liable for 36.63% of the contested taxes. As the court of appeals recognized (see *id.* at 36a), the underpayment interest owed by petitioners and the other tax-shelter participants on their remaining tax liabilities is not a penalty, but instead represents the compensation due the United States for the loss of the use of its funds from the time the taxes were required to be paid until the date the taxes are paid. See 26 U.S.C. 6601; *Grauvogel* v. *Commissioner*, 768 F.2d 1087, 1090 (9th Cir. 1985); see also *United States* v. *Childs*, 266 U.S. 304, 309-310 (1924). The tax-shelter participants who failed to pay their reduced tax deficiencies on time were granted "the equivalent of an interest-free loan of the reduced deficiencies and interest they will now have to pay." Pet. App. 36a (quoting *Dixon* v. *Commissioner*, 91 T.C.M. (CCH) 1086, 1105 (2006)). And, as explained above (see pp. 10-11, *supra*), petitioners would ultimately have been required to pay substantially more in tax and interest if the Commissioner's attorneys had not engaged in the misconduct for which sanctions were imposed. No equitable principle entitled petitioners to additional benefits beyond what the court of appeals determined was an appropriate sanction.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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